Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION SECOND QUARTER 2000

FDIC
New York
Region

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Regional Perspectives

◆ ***The Region's Economic Conditions*—Although the Region's economic growth rate lagged the nation's in 1999, the gap narrowed because of the strong stock market and a growing concentration of new high-value-added jobs. Forecasts by Regional Financial Associates call for the Region's economic growth to continue in 2000 but at a slower pace than the nation's. The strong economy has increased demand for commercial real estate, particularly in large urban areas. As a result, vacancy rates are falling and rents are rising in many of the Region's major cities.** ***See page 3.***

◆ ***The Region's Banking Conditions*—The Region's banks reported generally healthy conditions for the fourth quarter of 1999. Insured institutions benefited from increased noninterest income, stable credit quality, a steeper yield curve, and effective expense control. Lower charge-off rates reported by the Region's credit card specialists partially offset the effect of competitive pressures on margins. Although average credit card delinquency and charge-off rates have improved in the Region, in 1999 the nation's consumer debt service burden reached its highest level in ten years.** ***See page 6.***

◆ ***Rising Interest Rates Could Pose Risk to the Region's Insured Institutions*—The Region could be more sensitive to rising interest rates and changes in mortgage preferences than the nation, because almost one-third of the Region's banks are mortgage specialists, compared with 11 percent of banks elsewhere in the nation. Absent effective interest-rate hedging programs, higher interest rates could hamper earnings if funding costs increase faster than returns earned on assets. Furthermore, because mortgage specialists reported a larger percentage of assets in securities and a greater proportion of longer-term securities than other banks in the Region, the value of their investment portfolios may be more vulnerable in a rising interest rate environment.** ***See page 7.***

By the New York Region Staff

In Focus This Quarter

◆ ***Banking Risk in the New Economy*—This article summarizes current economic conditions, with a primary focus on potential risks to insured depository institutions. It explores the implications of long-term trends that have led to the *New Economy.* Recent high rates of economic growth with low inflation have been made possible by increases in productivity arising from new technologies, higher investment spending by businesses, and large-scale industrial restructuring. Underlying these trends has been a financial environment that has largely accommodated the growing borrowing needs of consumers and businesses. Market-based financing, provided in large part through securitizations and mutual funds, has made capital readily available to start-up "new economy" firms as well as mature companies that seek to merge or restructure. Despite the clear benefits of market-based financing in supporting economic activity, there are also concerns. A recurrence of financial market turmoil, such as that experienced in fall 1998, has the potential to quickly change the currently positive economic outlook to one that is far more challenging. Detail is provided on commercial credit quality, market sources of revenue, and other risks to watch in banking.** ***See page 11.***

By the Analysis Branch Staff

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Regional Perspectives

- **Although the Region's economic growth rate lagged the nation's in 1999, this gap narrowed because of the strong stock market and a growing concentration of new high-value-added jobs.**

- **The Region's banks benefited from increased noninterest income, stable credit quality, and a steeper yield curve in fourth quarter 1999. Lower charge-off rates reported by the Region's credit card specialists partially offset the effect of competitive pressures on margins.**

- **Profitability levels of the Region's mortgage specialists, which represent more than one-third of all banks in the Region, could be vulnerable to rising interest rates as consumer preferences for mortgage products change.**

The Region's Economic and Banking Conditions

Economic Conditions Remain Robust

The nation's economy ended the decade in the midst of its longest expansion on record, which is expected to continue in 2000, although at a gradually slowing pace. The ***Blue Chip Economic Indicators,*** a survey of 50 of the nation's prominent economists, calls for a 4.5 percent increase in gross domestic product, the broadest measure of the nation's economic activity, in 2000.[1] This forecast follows three consecutive years of economic expansion in excess of 4 percent. Forecasts for the Region also call for economic growth to continue but at a slower pace than the nation. During the 1990s, the Region's economy performed well, although its rate of growth was only two-thirds of the national rate, primarily because of slower population growth and higher business costs (see Chart 1). Although the Region's economic growth rate lags the national average, the gap narrowed in 1999 because of the strong stock market and a growing concentration of new high-value-added jobs in the Region.[2]

While the Region's economy is expected to expand in 2000, the rate of growth will vary among the states. According to ***Regional Financial Associates*** (RFA), the economies of **Maryland** and **New York State** are expected to expand more rapidly than the economies of other states in the Region and to match the nation's strong economic performance (see Table 1, next page). The economies of **Delaware** and **New Jersey** also are expected to perform well, although forecasts call for a rate of growth somewhat slower than the nation's. Economic growth in **Pennsylvania** is expected to slow in 2000, primarily because of limited population growth, tight labor markets, and reduced manufacturing activity.

Consumer spending, an important driver in the nation's and Region's economies, is expected to grow at a healthy pace based on surveys conducted by the ***New York*** and ***Philadelphia Federal Reserve Banks.*** Those surveys, which include most of the Region's states, estimate retail sales increases between 3 percent and 7 percent through the first three months of 2000, consistent with national trends.[3] Spending gains on home furnishings, apparel,

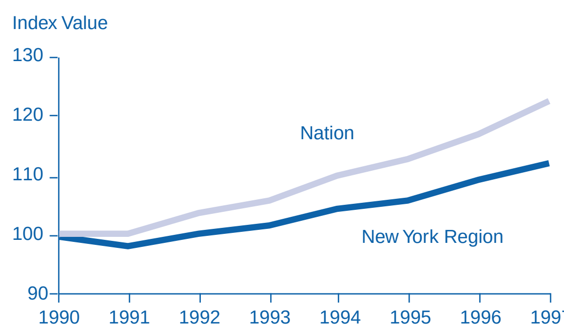
[1] Represents the April 2000 survey.

[2] The Region's and states' economies are measured by the gross state products. Forecasts for the Region are made by the Regional Financial Associates; forecasts are as of January 2000.

[3] New York and Philadelphia Federal Reserve Bank Beige Books. January 19, 2000, and March 8, 2000.

Chart 1

During the 1990s, the Region's Economy Expanded at Two-Thirds the National Rate



Source: National Income and Product Accounts. Region's economy is the sum of the state gross products, excluding Puerto Rico.

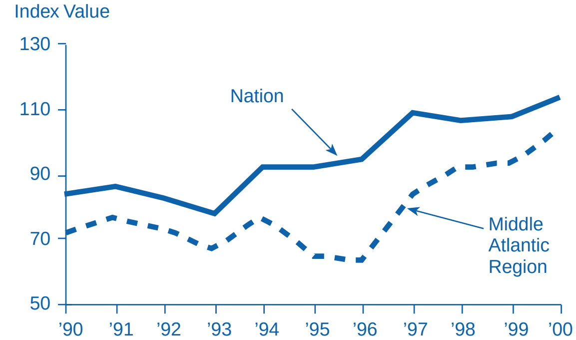
TABLE 1

MARYLAND AND NEW YORK ECONOMIES ARE FORECAST TO EXPAND MOST RAPIDLY IN THE REGION IN 2000		
STATE	AVERAGE ANNUAL GROWTH RATE 1990–1999 (%)	PROJECTED GROWTH RATE 1999–2000 (%)
DELAWARE	2.7	3.4
MARYLAND	1.9	3.5
NEW JERSEY	2.4	3.2
NEW YORK	1.8	3.7
PENNSYLVANIA	2.5	2.1
N.Y. REGION	1.9	3.2
UNITED STATES	3.2	3.6

SOURCE: NATIONAL INCOME AND PRODUCT ACCOUNTS. GROSS STATE PRODUCTS FOR 1998 AND 1999 ARE REGIONAL FINANCIAL ASSOCIATES ESTIMATES. PROJECTIONS FOR 2000 ARE MADE BY REGIONAL FINANCIAL ASSOCIATES. FORECASTS AS OF JANUARY 2000.

CHART 2

Surveys of Consumer Expectations Suggest Continued Spending



Note: 2000 represents first quarter only.
Source: Conference Board

appliances, and cosmetics were highlighted. The surveys indicate that merchants expect "a good selling climate" to prevail during the first half of 2000, and preliminary data during the first few months of 2000 show that spending is equal to or exceeds last year's volume. ***Conference Board*** surveys of consumer expectations suggest that despite some recent concern about oil prices and stock market volatility, consumers generally remain confident about the future (see Chart 2).

Gains in the financial services, high-tech, and computer-related industries also have contributed to the Region's economic growth. An RFA study stated that the information technology industry is growing in importance to the nation and Region.[4] Technology has been responsible for a significant share of the nation's improved productivity and job growth. In fact, the RFA study states that between 10 and 12 percent of the Region's jobs are related to information technology industries, roughly equal to the national average. Technology centers are being developed, particularly in the **Washington, D.C.**–Maryland corridor, **Philadelphia** suburbs, and **New York City.** New, but smaller, technology centers also could help invigorate the economies of **Rochester,** New York, and **Pittsburgh,** Pennsylvania, where local economic growth has lagged the rest of the Region. While information technology companies are a growing and vital component of the New Economy (see "Banking Risk in the New Economy," page 11), some of these entrants could be at risk if their performance does not meet Wall Street expectations or if equity and venture capital financing becomes more difficult to obtain.

Commercial Real Estate Markets Tighten

The strong economy has increased demand for commercial real estate in the Region, particularly in the large urban areas. Vacancy rates in New York City, Washington, D.C., and **Wilmington,** Delaware, are almost half the nation's average. Office space is so tight in New York City that rents easily exceed $50 per square foot in many class-A buildings and are approaching $100 per square foot in some areas. Office vacancy rates in downtown **Baltimore** stood at 9.1 percent in the third quarter of 1999, down from 18.1 percent two years earlier. While the 12.6 percent office vacancy rate in downtown Philadelphia was above the national average of 9 percent for downtown areas, the city's suburban vacancy rate was 8.5 percent, below the 10.1 percent national average.

At this late stage in the current economic expansion, vacancy rate trends in the Region's major metropolitan areas differ from those experienced immediately prior to the recession of the early 1990s. While vacancy rates for many metro areas were lower than the national average at that time, vacancies had started to rise in some of

[4] Zandi, Mark. September 1999. Information Economy. *Regional Financial Review*.

the Region's major cities. The recession of the early 1990s hit the Region's real estate markets harder than other parts of the nation, in part because a significant amount of new office construction was being completed just as the Region's economy was contracting and demand for space was declining. Many of the Region's cities reported declining vacancy rates through most of 1999.[5] As a result, the Region's commercial real estate markets appear better positioned in case of an economic downturn than these markets were ten years ago.

Although vacancy rates are still declining in most of the Region's cities, there are some areas of concern. For example, construction of office space has increased in eastern New Jersey, primarily in areas within commuting distance to higher-rent areas in New York City. Increased construction also is evident in the suburbs of Philadelphia and the Washington, D.C.–Baltimore area, and anecdotal evidence exists of speculative office development in the Pittsburgh; **Albany,** New York; and northern New Jersey markets. Although new office construction presently is substantially less than just before the last recession, an economic slowdown, depending on its depth and duration, could hurt the Region's office markets. Because developers traditionally initiate projects based on current market conditions rather than economic forecasts, the amount of office construction should be closely monitored.

Housing markets in many parts of the Region also are robust, following several years of stagnant prices, although they have not attained the growth rates of the late 1980s. Demand for new homes and resales has been particularly strong in areas experiencing the greatest levels of job growth. Home sales and residential construction increased in the latter half of the 1990s, particularly in the suburbs of New York City, Philadelphia, and the Washington, D.C.–Baltimore area; however, activity is still below levels reached during the 1980s in many of the Region's cities. According to the ***National Association of Realtors,*** the median price for a single-family home in the Washington, D.C., metropolitan area, for example, rose 4.4 percent between December 1998 and year-end 1999. In contrast, home prices in this area rose 12 percent in 1987 and 15 percent in 1988.

Permits for new single-family homes slowed in 1999, possibly in response to higher interest rates, rising 4 percent nationwide in 1999, compared with a 12 percent increase in 1998. In the first two months of 2000, permit growth slowed further to 1.2 percent, compared with the same period in 1999. The Region experienced a similar rate of permit growth. In 1998, permits for new single-family homes increased at double-digit rates in Delaware, Maryland, and New York. In New Jersey and Pennsylvania, the increase was close to 9 percent. In 1999, however, growth slowed to less than 3 percent in most of the Region's states. New York was the exception: new permits increased 6 percent, slightly higher than the nation's growth rate.

Region's Dependence on Wall Street Increases

The stock market has contributed greatly to the Region's economic expansion, more so than in other parts of the nation. According to a recent ***Federal Reserve Board Survey,*** stocks, mutual funds, and retirement accounts represented two-thirds of household financial assets[6] at year-end 1998, up from 42 percent at year-end 1989. Furthermore, nearly half of all households owned stocks in 1998, either directly or in mutual funds, compared with 32 percent of families ten years ago.[7] Stock ownership is more concentrated in the New York Region than in other Regions. Studies show that the Region's investors hold almost one-quarter of the nation's total equity investments.[8] In addition, Wall Street and related financial services industries have represented the primary source of earnings growth in New York City. Between 1994 and 1998, securities firms contributed approximately $23 billion to New York City's economy, or more than one-third of the increase in total salaries, compared with 4.3 percent for the nation.[9] The average salary for New York State's 186,000 securities and commodity brokers was approximately $230,000,[10] and the ***New York State Comptroller's Office*** estimated that bonuses on Wall Street totaled $11.4 billion in 1999, up 18 percent from one

[5] Vacancy rate data as of the third quarter of 1999. Source: C.B. Richard Ellis.

[6] Household financial assets include savings and checking accounts, stock, bonds, mutual funds, retirement accounts, cash value of life insurance policies, and other managed assets.

[7] Kennickell, Arthur B., Martha Starr-McCluer, and Brian J. Surette. 1999. Recent Changes in U.S. Family Finances, Results from the 1998 Survey of Consumer Finances. Federal Reserve Board, Division of Research and Statistics.

[8] The Investment Company Institute. 1995. State Distribution, Mutual Fund, Assets and Accounts.

[9] Securities Industry Association. March 2000 Update. The New York Securities Industry: Its Economic Impact on New York State and City.

[10] Based on 1997 earnings data supplied by the Bureau of Economic analysis. Represents most recent data available.

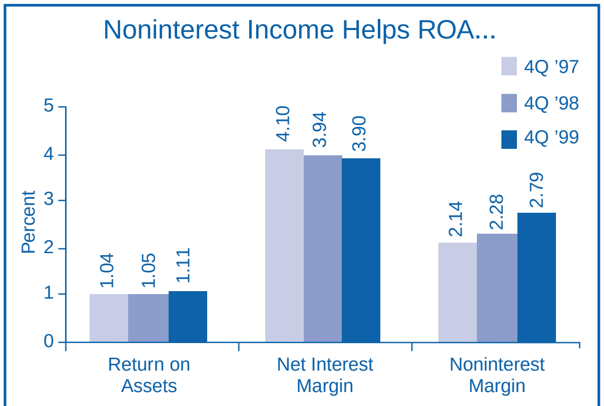
year ago. The economic multiplier of Wall Street is so significant that, for example, although the securities industry accounts for only 2 percent of the jobs in New York State, it was responsible for almost 60 percent of the increase in the state's gross product between 1992 and 1997. Because of the Region's dependence on Wall Street, a downturn in the stock market, if deep and sustained, could weaken the economy in the Region more than in other areas of the nation.

Strong Economy Helps Region's Insured Institutions and Credit Card Specialists

The Region's banks reported generally healthy conditions for the fourth quarter of 1999. Insured institutions benefited from stable credit quality, a steeper yield curve, increased noninterest income, and effective expense control.[11] With a flatter yield curve prevalent during 1998, the Region's average net interest margin (NIM) declined during the year. In the latter half of 1999, however, the average NIM rebounded as the yield curve steepened following increases in the Federal Funds rate. The ratio of loans to deposits also rose during the year, but the Region's banks faced competition for core deposits, which declined marginally as a percentage of assets (see Charts 3 and 4). Credit quality ratios improved for most loan segments, except for commercial and industrial loans, which showed a slight increase in the charge-off rate.

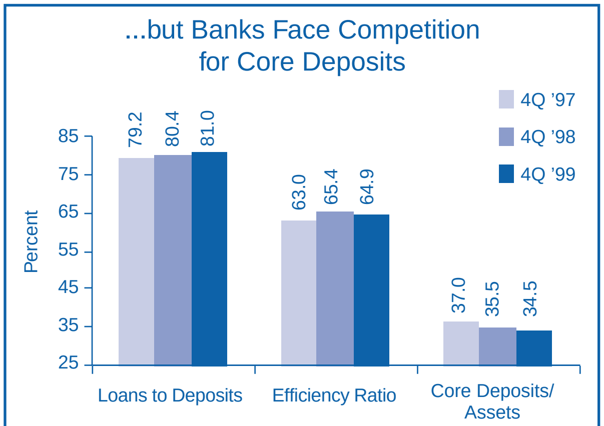
Results of the Region's credit card specialists[12] reflected intense competition and increased consolidation among credit card lenders. The increase in the number of credit cards held by consumers has slowed as response rates on mailed card solicitations declined from a peak of 2.8 percent in 1992 to 1 percent in 1999, an all-time annual low. In the past, response rates have declined as the volume of mailings increased, but in 1999 the number of mailed credit card solicitations actually declined. According to ***BAI Global, Inc.,*** a market research firm that tracks credit card solicitations, direct mail solicitations dropped 17 percent in 1999 from record mailings of 3.45 billion in 1998.[13] Some of the decline was attributed to the elimination of overlapping programs as card lenders merged or acquired competitors. Other lenders reduced mailings to combat margin pressures or shifted focus to new solicitation methods, including Internet-based marketing programs. Market saturation also contributed to lower response rates, as many consumers feel they have enough credit cards. With introductory rates on some credit cards nearing zero percent, card lenders have fewer ways to compete as the differences among card programs become less tangible.

CHART 3



Note: Excludes Region's credit card banks and banks less than three years old.
ROA = return on assets
Source: Bank and Thrift Call Reports

CHART 4



Note: Excludes Region's credit card banks and banks less than three years old.
Source: Bank and Thrift Call Reports

[11] Excludes banks that received charters after December 31, 1996, and banks that specialize in credit card lending.

[12] Credit card specialists are defined as insured institutions that report at least 50 percent of assets as loans and at least 50 percent of loans as credit card receivables.

[13] BAI Global, Inc. 1999. Credit Card Mail Volume Declines, As Consumer Response Rates Reach All-Time Low.

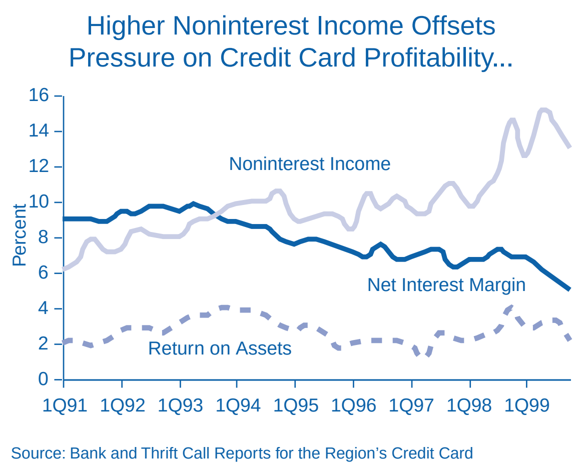
Industry trends affected the results of the Region's credit card specialists. The Region's nine credit card specialists, which accounted for 32.5 percent of total managed card receivables[14] reported by insured institutions nationwide as of December 31, 1999, reported a lower average return on assets (ROA) and average NIM for the fourth quarter of 1999 than the previous year. These trends were consistent with credit card specialists nationwide. Yields earned on prime credit card loans have declined as lenders have reduced rates to compete for accounts. Higher noninterest income buffered the effect of lower NIMs (see Charts 5 and 6). Card lenders increasingly have turned to additional forms of noninterest income, such as higher fees on late accounts and charges for balance inquiries, to counter lower yields earned on traditional credit card loans. (For more information, see "Noninterest Income Grows in Importance" in the ***New York Regional Outlook,*** first quarter 2000.) The Region's credit card lenders also benefited from a decline in the credit card charge-off rate. Lower personal bankruptcy filings (which declined by 8.3 percent in 1999), a strong economy, an influx of cash from mortgage refinancing, and improved underwriting and risk-based pricing enhanced credit quality ratios reported by the Region's credit card specialists. Although the number of bankruptcy filings is high historically, preliminary studies show that the downward trend in personal bankruptcy filings has continued through the beginning of 2000.[15]

Although returns on credit card lending continue to exceed returns earned by most of the banking industry, and credit quality measures improved in 1999, the outlook for the credit card segment nationwide is mixed. As interest rates declined from 1997 through the first half of 1999, some consumers paid off credit debt with proceeds from refinanced mortgage loans, alleviating pressure on credit card loans. Refinancings have declined, however, as interest rates climbed in early 2000, and a potentially slower economy could have implications for consumer credit quality. Although average credit card delinquency and charge-off rates have improved, the consumer debt service burden (the ratio of debt service payments on household consumer and mortgage debt as a percentage of disposable personal income) is rising; it reached 13.5 percent for 1999, the highest annual level since 1989.[16] Higher charge-off rates on credit card loans generally have tracked rising debt service burden (see Chart 7, next page). Consumers, of course, have benefited from stock market gains, which are excluded from disposable income; however, instability in the stock market could disrupt this supplemental repayment source.

Rising Interest Rates Could Pose Risk to Region's Economy and Insured Institutions

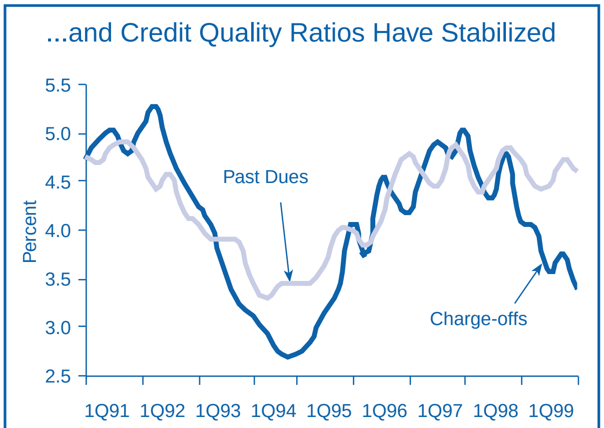
The ***Federal Reserve Board*** increased the Federal Funds target rate on five occasions between June 1999 and March 2000, for a total of 125 basis points. These increases have resulted in higher short- and long-term interest rates since December 1998 (see Chart 8, next page). The ten-year Treasury bond rate, for example,

Chart 5



Source: Bank and Thrift Call Reports for the Region's Credit Card

Chart 6



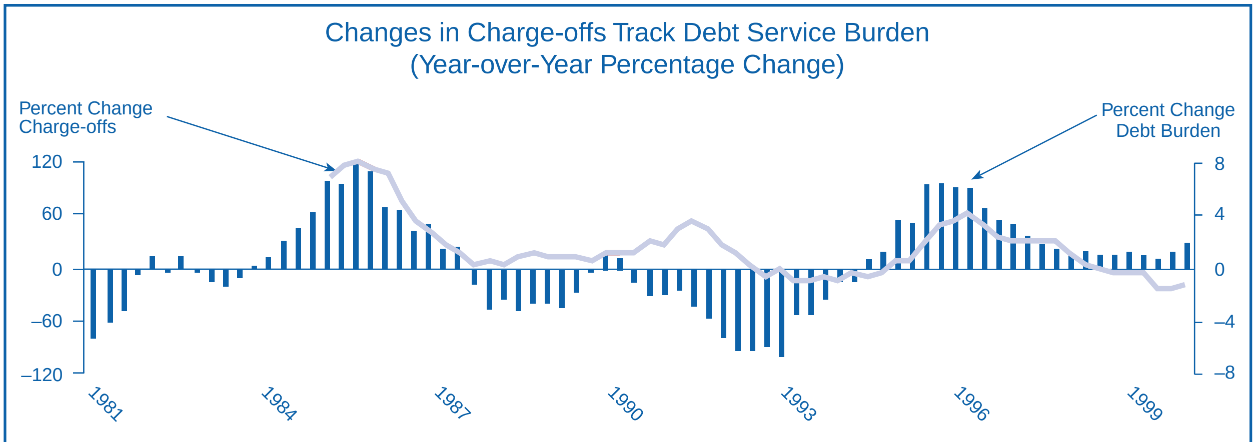
Source: Bank and Thrift Call Reports

[14] Managed credit card receivables include on-balance sheet and securitized credit card loans.

[15] CIBC World Markets. March 23, 2000. Credit Card Industry. Weekly filings through March 4, 2000.

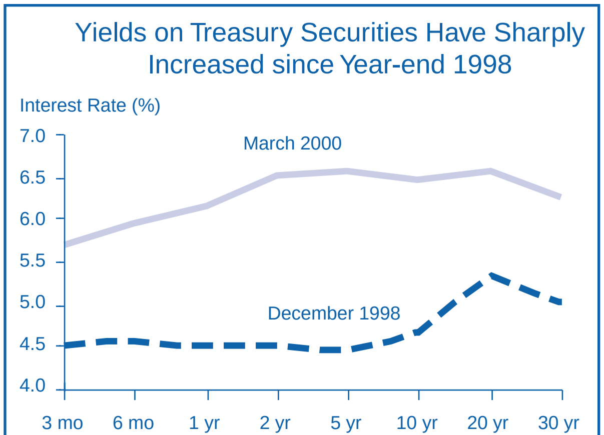
[16] Source: Federal Reserve Board.

CHART 7



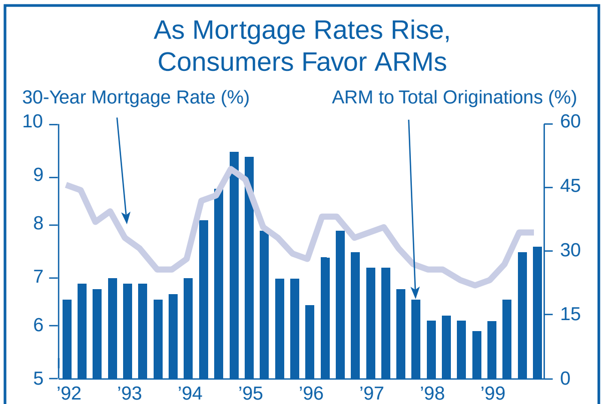
Sources: Bank and Thrift Call Reports; Federal Reserve Board.

CHART 8



Source: Federal Reserve Board.

CHART 9



Note: ARM = adjustable rate mortgage
Source: Federal Reserve Board, Federal Housing Finance Board, Monthly Interest Rate Survey. Data through fourth quarter 1999.

was 180 basis points higher at the end of first quarter 2000 than fourth quarter 1998. The Region's economic growth declined more than the nation's following hikes in the Federal Funds rate in the mid-1990s and could follow a similar pattern if rates continue to rise. (See "Higher Interest Rates May Curtail the Region's Economic Expansion" in ***New York Regional Outlook,*** fourth quarter 1999.)

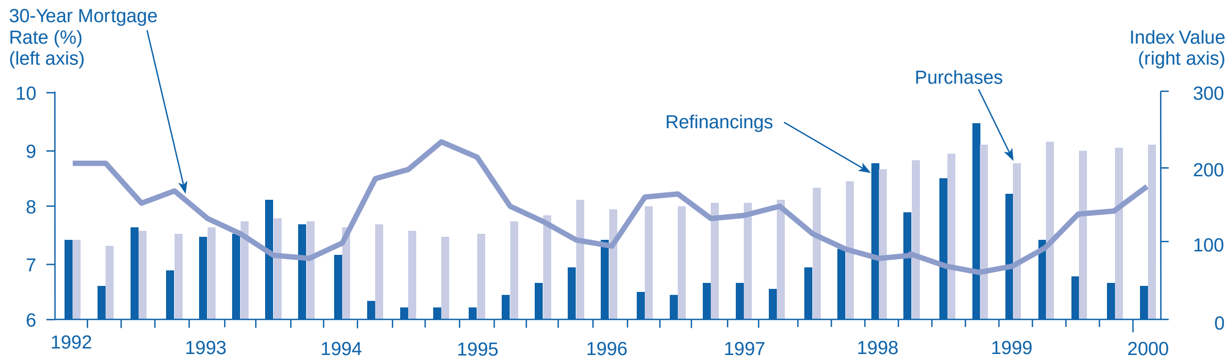
The decline and subsequent rise in interest rates during the latter half of the 1990s could affect interest margins earned by the Region's banks, particularly banks that specialize in mortgage lending. During 1997 and 1998, as long-term interest rates declined and the yield curve flattened, home purchasers and consumers who refinanced existing mortgages favored longer-term, fixed-rate loans over short-term adjustable rate mortgages (ARMs). Banks and other mortgage lenders responded to market demand by supplying long-term products at lower interest rates. During 1999, as long-term interest rates rose and the yield curve steepened, consumers switched to ARMs (see Chart 9). Refinancing activity and mortgage prepayments subsequently slowed, because it was no longer advantageous to refinance the 1997 and 1998 vintage mortgages at 1999's higher rates (see Chart 10).

The Region's banks could be more sensitive to rising interest rates and changes in mortgage preferences than banks elsewhere in the nation because almost one-third of the Region's banks are mortgage specialists, compared with 11 percent of banks elsewhere in the nation.[17] Mortgage specialists' NIMs could be constrained if interest

[17] Mortgage specialists are defined as banks that have at least 50 percent of assets in mortgage-related loans or securities.

Chart 10

As Mortgage Rates Have Increased, Refinancings Have Declined More than Purchases



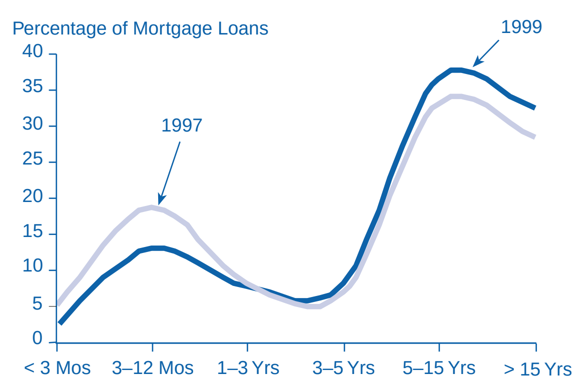
Source: Federal Reserve Board, Mortgage Bankers Association. Mortgages are conventional 30-year, Federal Home Loan Mortgage Corporation. Indices have been reindexed to first quarter 1992. Data through March 2000.

rates continue to rise because the maturity distribution of mortgage portfolios has lengthened since 1997, reflecting consumers' preference for longer-term mortgages (see Chart 11). Concurrently, the proportion of volatile liabilities[18] at these banks has risen as reliance on shorter-term, noncore funding has increased, reflecting stiffer competition for core deposits (see Chart 12). Although the Region's mortgage specialists reported a higher ratio of core deposits to assets than the average for all banks in the nation, the percentage has declined over the past five years. Higher interest rates could squeeze earnings if the mismatch between the maturity and pricing intervals of loan portfolios relative to a bank's liabilities is significant. Furthermore, banks and other mortgage holders may be faced with holding these lower-rate, long-term mortgages in their portfolios or selling them at a loss until rates decline below pre-1999 levels. In addition, while a reduced pace of refinancings could stabilize the Region's mortgage servicing income, a drop in mortgage originations could result in lower mortgage fees, an important source of income for mortgage lenders.

Not only are mortgage specialists vulnerable to rising interest rates because of changes in mortgage demand, but they rely on spread income more than the rest of the industry. Although the proportion of interest income to operating income has declined, the Region's mortgage specialists generated almost 75 percent of operating income from interest income in fourth quarter 1999, compared with 47 percent for the rest of the Region's

Chart 11

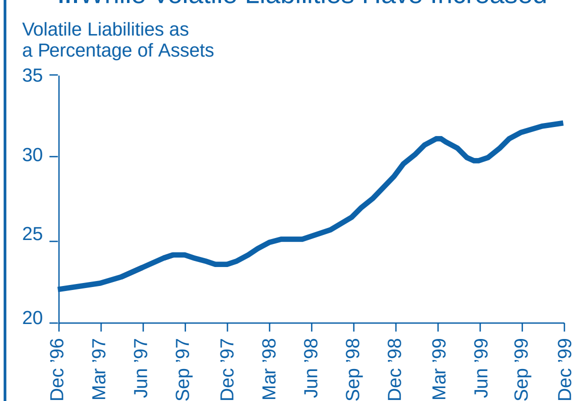
Mortgage Maturities Have Extended...



Source: Bank and Thrift Call Reports. Mortgage specialists as of 12/31/99.

Chart 12

...While Volatile Liabilities Have Increased



Source: Bank and Thrift Call Reports. Mortgage Specialists as of 12/31/99.

[18] Volatile liabilities are funding sources that typically have short-term maturities or are subject to repricing in the short term.

banks. Furthermore, mortgage specialists also generate lower NIMs because yields on traditional mortgages tend to be lower than for other types of loans. In fourth quarter 1999, the average NIM for the Region's mortgage specialists was approximately 100 basis points lower than the average NIM for all banks in the Region, consistent with past years.

Rising interest rates also could affect the valuation of bank securities portfolios. Mortgage specialists may be more vulnerable to changes in securities values because this group holds a larger percentage of assets in securities. As of December 31, 1999, the Region's mortgage specialists held almost one-third of total assets in securities, compared with 19 percent for all banks in the Region. This relationship was similar for all banks nationwide. Furthermore, the maturity structure of securities portfolios held by the Region's mortgage specialists lengthened during the past two years. At year-end 1999, approximately 31 percent of securities held by these institutions had maturities greater than 15 years, compared with just under 10 percent one year earlier. In contrast, securities with maturities greater than 15 years represented between 20 and 23 percent of securities for the rest of the Region's banks during the same period. Because security prices move inversely with interest rates and prices of longer-term securities are more sensitive to interest rate changes than shorter-term securities are, the value of security portfolios held by the Region's mortgage specialists could be at greater risk in a rising rate environment. In fact, in fourth quarter 1999, the Region's 117 commercial banks that specialize in mortgage lending reported net *depreciation* in securities' value equal to 9.8 percent of average Tier 1 capital compared with net *depreciation* equal to 5.1 percent for the rest of the Region's banks.[19]

[19] Bank Call Report. Thrifts do not report securities' appreciation and depreciation. Net appreciation and depreciation amounts were calculated on changes in values for securities held to maturity and unrealized gains or losses on securities held for sale.

Implications

Swings in mortgage preferences, reduced levels of refinancings, and rising interest rates could challenge the interest rate risk management programs of the Region's mortgage specialists. During the past two years, the maturity of mortgage assets reported by the Region's mortgage specialists has lengthened as homeowners took advantage of declining interest rates by refinancing into or originating new long-term, fixed-rate mortgages. During the same time, the proportion of shorter-term, volatile liabilities reported by the Region's mortgage specialists rose, reflecting increased competition for core deposits. Absent effective interest-rate hedging programs, mortgage specialists' margins may be pressured if funding costs increase faster than returns earned on assets. Furthermore, because mortgage specialists reported a larger portion of long-term securities than other banks in the Region, the value of their investment portfolios may be more vulnerable to rising long-term interest rates. Faced with margin compression, some mortgage specialists may be tempted to invest in higher-yielding, traditionally higher-risk securities to supplement income. Although mortgage specialists should benefit from increases in the spread between Treasury benchmarks and mortgage rates that occurred in early 2000,[20] changes in mortgage demand coupled with rising interest rates could stress the profitability of the Region's mortgage specialists.

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[20] Barta, Patrick. April 7, 2000. Mortgage Rates, Strangely, Remain Aloft. *The Wall Street Journal*.

Banking Risk in the New Economy

The Division of Insurance periodically assesses conditions in the economy and the banking industry to identify and evaluate trends that could adversely affect the performance of insured depository institutions. At this time, the banking industry as a whole continues to enjoy record profits and solid financial ratios.[1] Much of the industry's strength derives from the remarkable performance of the U.S. economy, which has been expanding for the past nine years. This article explores factors that have shaped this unusually robust economic environment and discusses how changes in the economy may create new types of risks for insured depository institutions.

During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. This loss primarily resulted from an uptick in unanticipated and high-cost bank failures. Some of these failures were associated with high-risk activities such as subprime lending, and some were related to operational weaknesses and fraud. The emergence of these problems in the midst of a strong economic environment raises concerns about how the condition of the banking industry might change if economic conditions deteriorate.

The Longest U.S. Expansion

In February 2000, the U.S. economy entered its 108th month of expansion, making this the longest period of uninterrupted growth in U.S. history.[2] This record-setting performance has also been marked by a recent acceleration in the rate of real gross domestic product (GDP) growth, which has exceeded 4 percent in each year since 1997. Meanwhile, price inflation has remained relatively subdued. The core inflation rate, which excludes the volatile food and energy components, was just 2.1 percent in 1999, the lowest core rate since 1965.

Recent economic conditions have been highly conducive to strong loan growth, low credit losses, and record earnings for the banking industry. The important question going forward is how long these favorable conditions might last. Is this remarkable economic performance the result of some long-term upward shift in the pace of economic activity, or is it the temporary result of a few transitory factors? More important, are there new and unfamiliar dangers that, at some point, could significantly impair banking industry performance? To evaluate these questions, we must assess the factors that have contributed to recent economic performance and think ahead to possible developments that could end this expansion.

What Is the New Economy?

The term used most often to describe the recent period of economic performance has been somewhat controversial: the *New Economy.* Much of the controversy has arisen because people interpret the term in different ways. Wall Street analysts use the term to refer to the high-technology sectors of the economy, such as computers and software, biotechnology, and especially the Internet. Some of these New Economy firms have been able to raise large amounts of capital and command market valuations in the tens of billions of dollars well in advance of earning a profit or even booking significant cash revenues.

Economists tend to employ the term New Economy in a slightly different way. To them, it refers to evidence that some of the traditional economic relationships have changed. For example, intangible assets now appear to play a much larger role in the valuation of investments than they have in the past.[3] Firms in some industries now may exhibit increasing returns to scale (rather than diminishing returns), reflecting the fact that the value of their product rises as it becomes a de facto industry standard.[4] Individual decision making, too, may be changing. Some believe that investors have reduced the risk premium they demand to hold equity positions

[1] For a recent summary of financial performance and condition of the banking and thrift industries, see the FDIC *Quarterly Banking Profile,* fourth quarter 1999, http://www2.fdic.gov/qbp/.

[2] The chronology of U.S. business cycles is available from the National Bureau of Economic Research, http://www.nber.org/cycles.html.

[3] Nakamura, Leonard. Federal Reserve Bank of Philadelphia. July/August 1999. Intangibles: What Put the New in the New Economy? *Business Review.* http://www.phil.frb.org/files/br/brja99ln.pdf.

[4] Brown, William S. March 2000. Market Failure in the New Economy. *Journal of Economic Issues,* 219–27.

because of their perception that holding equity is not, after all, substantially riskier than holding debt.[5] Such a shift in investor attitudes could help explain why the price-to-earnings ratio for the S&P 500 index has recently approached all-time highs.[6]

Perhaps the most important underlying change in the economy is the relationship between high rates of economic growth and changes in inflation. Economists have long maintained that rapid growth in economic activity has a tendency to lead to excess demand for goods (thereby raising consumer and producer prices) and excess demand for labor (thereby raising wage rates). But during the late 1990s, as growth accelerated and inflation remained low, economists began to reevaluate their notions of these trade-offs. Some argued that the low rate of inflation during this expansion was the fortunate result of temporary factors, such as a strong dollar and low energy prices, both of which could diminish or reverse direction over time.[7] Only a few analysts were so bold as to suggest that the fundamental workings of the economy had changed in such a way as to allow a sustained period of high economic growth with low inflation.

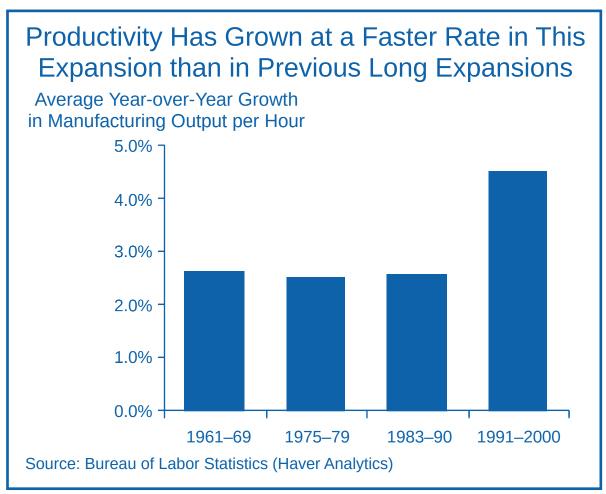
An early Wall Street description of the New Economy appeared in an article released by ***Goldman Sachs*** in January 1997.[8] It describes a number of fundamental changes in the economy—driven by global competition and advancing technology—that may permit business cycle expansions to last longer than they have in the past. At the same time, it warned that longer economic expansions might have a tendency to contribute to greater financial excess and the possibility of more severe recessions and more sluggish recoveries.

If this hypothesis is correct, and an emerging New Economy would contribute to longer expansions and more severe recessions, there may be implications for how banks manage risks. Since the Great Depression, U.S. business cycle recessions have not necessarily been catalysts for large numbers of bank and thrift failures. During the period from 1983 to 1989, when the U.S. economy was in the midst of a long expansion, some 1,855 insured banks and thrifts failed. This wave of failures has been attributed to a variety of factors, including severe regional economic downturns, real-estate-related problems, stress in the agricultural sector, an influx of newly chartered banks and banks that converted charters, and high nominal interest rates.[9] However, the potential for significantly more severe national recessions would represent largely uncharted territory that could cause losses and loss correlations to depart from historical norms, posing a new set of risk management challenges for the industry going forward.

The Productivity Revolution

As the essential element that links faster economic growth and low inflation, productivity growth is the cornerstone of the New Economy. Productivity refers generally to the amount of output that can be obtained from a fixed amount of input. Labor productivity is usually measured in terms of output per hour. Chart 1 shows that output per hour in manufacturing has risen at an average annual rate of 4.5 percent during the current expansion, compared with rates of just over 2.5 percent in the three previous long economic expansions. Moreover, productivity growth accelerated in 1999 to a rate of 6.3 percent. Why is productivity growing so fast now compared with previous expansions? Even economists who believe that economic relationships have funda-

CHART 1



[5] January 24, 2000. Has the Market Gone Mad? *Fortune.*

[6] September 1999. Earnings: Why They Matter. *Money.*

[7] Brown, Lynn Elaine. Federal Reserve Bank of New England. May/June 1999. U.S. Economic Performance: Good Fortune, Bubble, or New Era? *New England Economic Review.* http://www.bos.frb.org/economic/pdf/neer399a.pdf, and Brinner, Roger E. Federal Reserve Bank of New England. January/February 1999. Is Inflation Dead? *New England Economic Review.* http://www.bos.frb.org/economic/pdf/neer199c.pdf.

[8] Dudley, William C., and Edward F. McKelvey. January 1997. The Brave New Business Cycle: No Recession in Sight. *U.S. Economic Research,* Goldman Sachs.

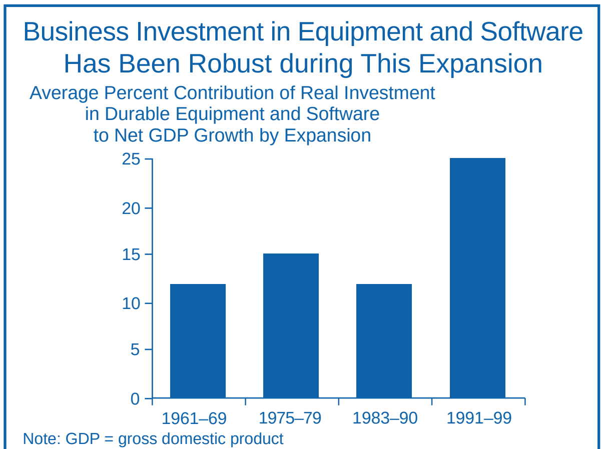
[9] FDIC Division of Research and Statistics. 1997. *History of the Eighties: Lessons for the Future, Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s,* 16–17. http://www.fdic.gov/bank/historical/history/contents.html.

mentally changed are hard-pressed to explain why all of the factors came together in the late 1990s and not before.[10] Still, explanations for the increase in productivity tend to focus on three main factors.

Increased Competition. Expanding global trade during the 1980s and 1990s has subjected U.S. firms to new competition from around the world. Annual U.S. exports of goods and services grew by over 230 percent (after inflation) between 1982 and 1999, while imports grew by 315 percent. The construction of new production facilities around the world in industries such as autos and chemicals has led to excess manufacturing capacity that has kept prices low. In other industries, including air travel, trucking, telecommunications, and banking, competition has been intensified through domestic deregulation. Facing intense competitive pressures and a low rate of general price inflation, firms cannot rely on annual price increases to help expand top-line revenue. Instead, there is pressure to continually cut costs in order to increase earnings. For many firms, this means adopting new technologies and new ways of organizing operations.

Expanded Investment. U.S. firms of all sizes have invested in new technologies at a rapid pace during this expansion. Chart 2 shows that business investment in equipment and software represents almost one-quarter of total net GDP growth during this expansion, compared with around 15 percent or less during previous long expansions. While this investment has been motivated by the need to cut costs, it has also been fueled by the availability of new computer technologies that have fallen in cost over time and by the ready availability of financial capital on favorable terms.

CHART 2

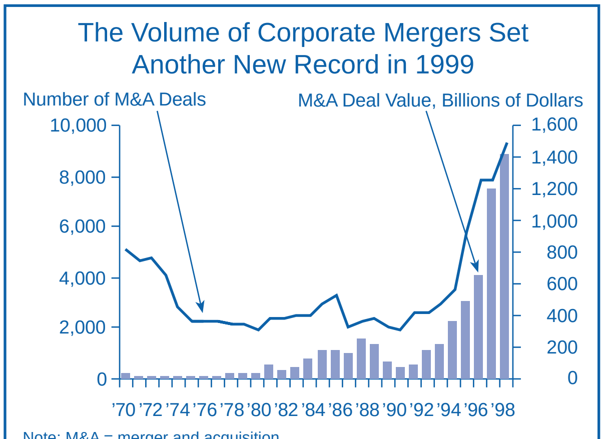


Note: GDP = gross domestic product
Source: Bureau of Economic Analysis (Haver Analytics)

Industrial Restructuring. The third aspect of the productivity revolution is large-scale restructuring in the U.S. corporate sector. Chart 3 shows that both the annual number and dollar volume of mergers in the late 1990s far exceeded the pace of the so-called merger mania of the late 1980s. Two classes of firms are leading the new wave of mergers. First, companies in mature industries such as oil, autos, and banking are faced with excess productive capacity and intense price competition. For these firms, mergers are useful in expanding market share and removing redundant operations. Second, the largest dollar volume of mergers is in some of the most volatile emerging industries, including telecom, media, and the Internet. It is in these sectors of the economy, in particular, where the business models are evolving rapidly and where technological standards are still being determined. Firms in these industries that can grow rapidly through mergers have the chance to achieve long-term market dominance in what appear to be some of the fastest growing industries of the new century.

The implications of the productivity revolution for the banking industry have been decidedly positive. Higher productivity has allowed a long expansion and faster economic growth with low inflation, all of which are conducive to robust financial performance by depository institutions. Higher rates of business investment

CHART 3



Note: M&A = merger and acquisition
Source: Houlihan Lokey's Mergerstat

[10] One possible explanation is that there is a learning curve for adopting new technologies and that technology diffusion is an inherently slow process. David, Paul A. Organization for Economic Cooperation and Development. 1991. Computer and Dynamo: The Modern Productivity Paradox in a Not-Too-Distant Mirror. In *Technology and Productivity: The Challenge for Economic Policy,* 315–47.

have generated demand for credit that is supplied, in part, by banks and thrifts. Perhaps most important, the recent large-scale industrial restructuring has been highly supportive of strong business credit quality. This process has moved economic resources to more productive uses in an orderly fashion, without the high levels of bankruptcies and defaults that often accompany industrial restructuring. Given the volumes of corporate assets that have changed hands in recent years (more than $1.4 trillion in 1999 alone), it is fortunate indeed that this restructuring has proceeded in this fashion.

The Role of the Capital Markets

A critical factor in heightened business investment and restructuring during this expansion has been the remarkably favorable conditions in the financial markets. Financial capital has generally been readily available to business borrowers, usually on favorable terms. One factor that has held down the cost of capital for publicly traded corporations has been sharply rising stock prices. Many of these firms have been able to use equity shares as a currency with which to finance mergers. Furthermore, existing accounting rules do not always require the amortization of good will that comes onto the balance sheet as a result of a merger.[11]

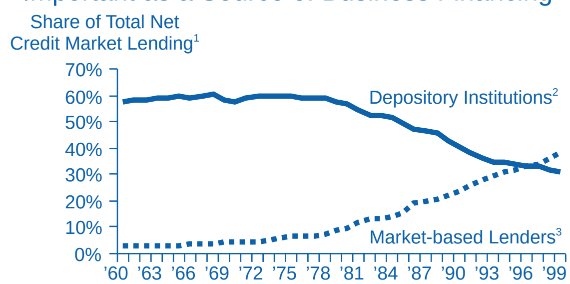
By far the largest amount of external business financing has been debt financing. U.S. nonfinancial corporations issued net debt in the amount of $535 billion in 1999 and repurchased equity shares, on net, for the sixth consecutive year. Businesses have used this debt to purchase capital equipment, finance mergers, and buy back equity shares. This increase in debt issuance has not been limited to highly rated corporations. Venture capital financing amounted to almost $15 billion in the fourth quarter of 1999 alone, with over 60 percent of that amount going to Internet firms.[12]

Banks have been active participants in nearly every facet of this financing activity. Syndicated loan origination volumes rose by 17 percent in 1999 to just over $1 trillion, despite relatively high credit costs and facility fees, factors that helped keep total volume below 1997's record $1.1 trillion in issuance. Syndicated loans to leveraged companies also rose 17 percent in 1999 to a record $320 billion. More impressive still was the growth in high-yield transactions, which rose nearly 50 percent in 1999 to $190 billion. It is difficult to determine precisely how much syndicated loan exposure resides on the books of insured institutions or, more important, how much high-yield exposure is retained by commercial banks. ***Loan Pricing Corporation*** estimates that 64 percent of high-yield volume in the first half of 1999 was retained by banks.[13] Insured commercial banks are the dominant originators of syndicated loans, with a 79 percent market share of investment-grade originations and a 56 percent market share of non-investment-grade originations in 1999. Commercial banks have also expanded their presence in the venture capital market. For some of the largest banks, profits from venture capital operations account for a large portion of total earnings. Chase Manhattan reported venture capital investment earnings of $2.3 billion in 1999, accounting for 22 percent of total net income.[14]

Innovation in the capital markets continues to provide new and more efficient vehicles for business financing. For example, issuance of asset-backed securities totaled $346 billion in 1999, up from only $50 billion in 1990. In this ongoing revolution in finance, market-based intermediaries, such as mutual funds and asset pools, have assumed an increasing role in the credit markets. Chart 4 shows that net holdings of credit market instruments by mutual funds, government-sponsored enterprises, and asset pools exceeded the debt held by depository institutions for the first time in 1997.

CHART 4

Market-based Lending Is Becoming More Important as a Source of Business Financing



1 Total net credit market lending is defined as net holdings of open-market paper, government and municipal securities, corporate and foreign bonds, mortgages, and other loans.
2 Depository institutions include commercial banks, savings institutions, and credit unions.
3 Market-based lenders include mutual funds, closed-end funds, government-sponsored enterprises, and asset pools.
Sources: Federal Reserve Board (Haver Analytics); Regional Financial Associates

11 April 17, 2000. Techdom's New Bean-Counting Battle. *Business Week.*

12 May 2000. Venture financing data are derived from a PriceWaterhouseCoopers/Money Tree survey, as cited in *Upside,* 43.

13 September 13, 1999. Junk Loan Market Is Feeling the Pinch of Oversupply and Rising Interest Rates. *The Wall Street Journal.*

14 April 3, 2000.What's Really Driving Banks' Profits. *Business Week.*

While the expansion in market-based financing has made credit more available to business and consumer borrowers, it also creates some concerns. One issue is the susceptibility of the financial markets to periodic bouts of turmoil. These episodes, such as the one triggered by the Russian government bond default and the near-failure of the Long Term Capital Management hedge fund in the fall of 1998, can result in the interruption of capital flows even to creditworthy borrowers. During the 1998 episode, private yield spreads widened sharply as investors sought the safety of U.S. Treasury securities. Some companies that had planned to issue debt to the markets during that period were unable to do so. For companies whose business models depend heavily on a continuous supply of liquidity from the financial markets, the effects of these episodes can be catastrophic. For example, the relatively short-lived episode of financial turmoil during late 1998 resulted in significant liquidity problems for a number of commercial mortgage firms. Nomura, Lehman Brothers, CS First Boston, and others incurred losses, while Criimi Mae, Inc., was forced to declare bankruptcy.

Because market-based financing has played such a large role in facilitating the orderly restructuring of the U.S. economy through mergers and the formation of new businesses, a recurrence of financial market turmoil could contribute to the end of the current expansion. Moreover, such an event could have serious consequences for business credit quality. A prolonged interruption of market-based financing could, in this very competitive economic environment, prevent businesses from restructuring themselves through mergers and deprive them of capital needed to invest in cost-cutting technologies. The loss of financial flexibility would leave businesses much more vulnerable to the effects of competition and could result in more firms seeking bankruptcy protection. Such a scenario has the potential to bring about a significant increase in charge-off rates for business lenders.

Financial Imbalances

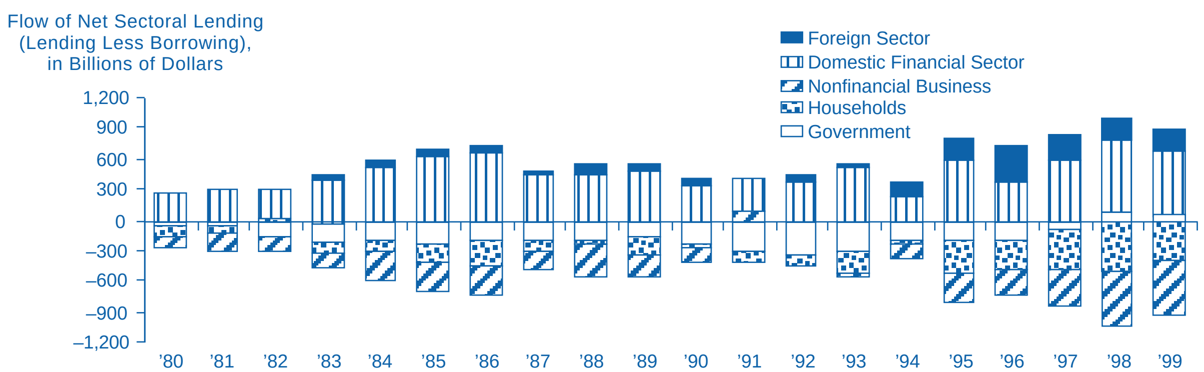
Another concern that arises from increased dependence on market-based financing is that it may contribute to the emergence of financial imbalances in the economy. These imbalances could, in turn, increase the potential for financial market turmoil as a result of some unforeseen shock to the markets.

As recently as 1993, the public deficit was near the top of the list of economists' concerns about the U.S. economy. During that year, the combined deficit of the federal, state, and local government sectors exceeded $300 billion. However, on the strength of a long economic expansion, lower interest rates, and lower federal spending on defense, the consolidated government sector posted its second consecutive surplus in 1999 (Chart 5).

As the government has moved from deficit to surplus, households and businesses have continued to borrow hundreds of billions of dollars every year. Taken together, the annual net borrowing of businesses and households has been referred to as the "private deficit." In 1999, the private deficit narrowed to $913 billion from a record $1.02 trillion the year before. Although this private borrowing indicates confidence on the part of consumers and businesses about future prospects, it also raises concerns about the ability to service debt if interest costs rise or if incomes level off or decline.

CHART 5

Net Borrowing by Businesses and Households Represents a Growing "Private Deficit"



Note: "Nonfinancial business" includes farm and nonfarm, corporate and noncorporate businesses.
Source: Federal Reserve Board (Haver Analytics)

The largest part of the private deficit was again financed in 1999 by domestic financial institutions ($649 billion) and an inflow of capital from abroad ($207 billion). Both of these sources of financing are potential causes for concern. The rapid expansion in credit created by the financial sector raises questions about credit quality. Financial institutions theoretically serve as the gatekeepers of the economy, financing only the most creditworthy projects and rejecting those that are not viable. The sheer volume of credit extended to businesses and households—almost $1.4 trillion in new net lending over the past two years—raises the possibility that underwriting has become more lax and that average credit quality is slipping. (See the inset box on page 17 for a discussion of recent trends in commercial credit quality.)

Reliance on inflows of foreign capital raises a different set of issues. The fact that the U.S. economy has been growing significantly faster than the economies of its major trading partners has contributed to a U.S. trade deficit that reached $268 billion in 1999 and could exceed $300 billion in 2000. This deficit puts hundreds of billions of dollars annually in the hands of foreign investors. As long as foreign investors largely choose to reinvest their excess dollars in U.S. factories and financial instruments, as has been the case in recent years, the United States can continue to enjoy a strong dollar and relatively low inflation and low interest rates. However, if foreign investors should choose to invest elsewhere, they must sell their dollars in foreign exchange markets. Doing so would put downward pressure on the dollar and upward pressure on U.S. inflation and interest rates.

Recent Shocks to the U.S. Economy

Despite the potential for a declining dollar as a result of U.S. reliance on foreign capital, other adverse developments have confronted the U.S. economy over the past year. The two factors of most consequence to the macroeconomic outlook have been rising energy costs and rising interest rates. These trends have played a role in recent equity market volatility that may have implications for the future direction of the economy.

Rising Energy Prices. After declining to a low of around $10 per barrel in December 1998, oil prices have risen dramatically over the past year and a half. The spot price per barrel of West Texas Intermediate crude peaked in March 2000 at just under $30 before declining slightly in April. The rapid increase in oil prices during 1999 was sparked by a cutback in output by oil-producing nations that was instituted just as global economic growth was recovering from the crisis of 1998. The OPEC nations and other major oil producers reached a new agreement in March 2000 that provides for a production increase of some 1.5 million barrels a day. But, because demand is rising and gasoline inventories remain lean, analysts do not look for a significant decline in gasoline prices in the near term.[15]

The effects of higher oil prices on the U.S. economy at this time are uncertain. According to some estimates, the economy is only half as dependent on oil as it was 25 years ago, when the United States was experiencing the effects of its first "oil shock."[16] Still, higher oil prices were responsible for nearly all the increase in consumer price inflation during 1999. While year-over-year growth in the Consumer Price Index rose from 1.6 percent in December 1998 to 2.7 percent in December 1999, the core rate of inflation (excluding food and energy items) actually fell. The question now is whether higher energy prices will be passed along to the rest of the economy through rising wage and price demands during the remainder of 2000.

Rising Interest Rates. From low points at the end of 1998, both short-term and long-term interest rates have risen substantially, contributing to a higher cost of debt service for businesses and households. At the short end of the yield curve, the Federal Reserve (the Fed) raised the Federal Funds rate six times between June 1999 and May 2000, for a total increase of 175 basis points. While part of this increase merely reversed the reduction in rates that took place in late 1998, the Fed also voiced concerns that inflationary pressures might be emerging because of continued rapid U.S. economic growth. Given the stated commitment of the Federal Reserve to price stability, most analysts expect the Fed to continue to push short-term rates higher until growth in the economy slows to a more sustainable pace.[17]

Bond markets also pushed up long-term interest rates during this period. The yield on the ten-year Treasury

[15] Energy Information Agency (U.S. Department of Energy). April 2000. Short-Term Energy Outlook. http://www.eia.doe.gov/emeu/steo/pub/contents.html.
[16] March 11, 2000. Fueling Inflation? *The Economist.*
[17] See, for example, U.S. House of Representatives. February 17, 2000. Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services. http://www.federalreserve.gov/boarddocs/hh/2000/February/Testimony.htm.

As Commercial Credit Quality Indicators Slip, Trends in Commercial Lending Come to the Forefront

Commercial lending, which includes both commercial and industrial (C&I) and commercial real estate (CRE) loans, represents the greatest source of credit risk to insured institutions and the deposit insurance funds. C&I loan growth continued to be strong in 1999, although it did moderate from 1998 levels, and recent underwriting surveys have reported a slight tightening of terms.[18] Nevertheless, there are signs that commercial credit quality is deteriorating.[19] Most notably, as seen in Chart 6, C&I loan charge-off rates, corporate bond defaults, and corporate bond rating downgrades relative to upgrades have all been trending upward recently. For example, C&I loan loss rates rose to 0.56 percent of total loans in 1999, nearly double the rate of loss experienced in 1997. Although C&I loan loss levels are well below historical highs experienced throughout the 1980s and early 1990s, these signs of credit quality deterioration are occurring despite extremely favorable economic conditions.

At least three factors have contributed to weakening in corporate credit quality. First, corporate indebtedness has been rising, as businesses have been spending to increase productivity, cut costs, repurchase equity, and finance mergers and acquisitions. The second factor relates to a greater risk appetite in the financial markets. For example, originations of leveraged syndicated loans—in particular, highly leveraged loans—have tripled over the past five years. Finally, stresses within industry sectors hard hit by structural changes, global competition, and deflationary pressures have resulted in challenges for borrowers.

Construction and development (C&D) lending continues to be one of the fastest growing segments of banks' loan portfolios, while loss rates among CRE and C&D loans remain extremely low. However, there are indications that conditions could be worsening in some markets. In particular, as shown in Chart 7, strong office completions and construction activity have begun to outpace absorptions and are projected to continue to do so over the next several years. Moreover, these trends have implications for vacancy rates. The national office vacancy rate moved higher during 1999 for the first time since 1991 and is projected to climb higher.

In addition, some local CRE markets continue to show signs of overbuilding. Last year, the FDIC's Division of Insurance identified nine markets in which the pace of construction activity threatened to outstrip demand for at least two property sectors.[20] Seven of these nine markets reported an increase in office vacancy rates in 1999.

Chart 6

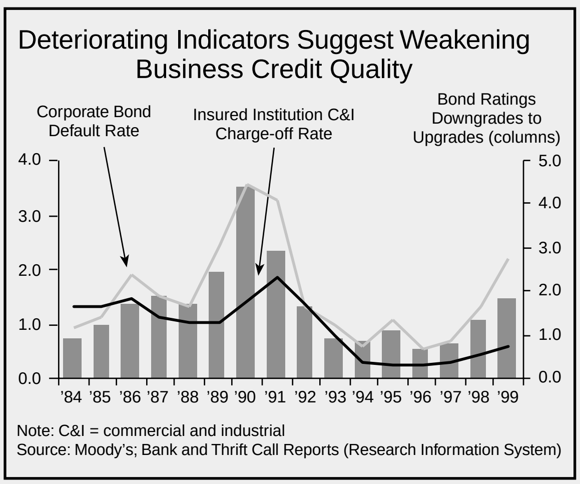
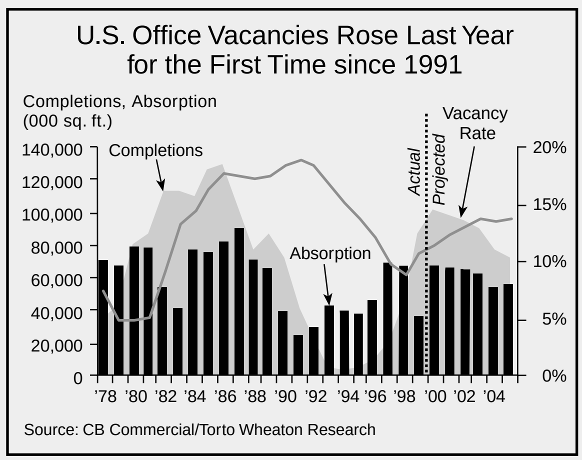


Chart 7



[18] Both the 1999 *Senior Loan Officer Opinion Survey* (Federal Reserve Board) and 1999 *Survey of Credit Underwriting Practices* (Office of the Comptroller of the Currency) point to more stringent C&I loan terms since the latter part of 1998. This tightening follows a four-year period of easing C&I loan standards and predominantly reflects an increase in loan pricing.

[19] For additional detail, see Sothoron, Arlinda, and Alan Deaton. FDIC Division of Insurance. First quarter 2000. Recent Trends Raise Concerns about the Future of Business Credit Quality. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro20001q/na/Infocus1.html.

[20] These markets are Charlotte, Orlando, Salt Lake City, Dallas, Las Vegas, Phoenix, Nashville, Atlanta, and Portland. See Burton, Steve. FDIC Division of Insurance. First quarter 1999. Commercial Development Still Hot in Many Major Markets, But Slower Growth May Be Ahead. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro19991/na/Infocus2.html.

note rose from a low of 4.5 percent in October 1998 to 6.5 percent by May 2000. Analysts have cited renewed demand for credit by a recovering world economy as well as concerns about inflation arising from the increase in energy prices as factors behind the rise in long-term rates.

Higher energy costs and higher interest rates do not appear to have significantly slowed the pace of U.S. economic activity during the first quarter of 2000. The preliminary estimate of real gross domestic product growth during the quarter was 5.4 percent—a slowdown from the 7.3 percent rate of the fourth quarter of 1999 but still well above what is considered a sustainable pace. Home construction, usually a sector that is particularly sensitive to movements in long-term interest rates, has remained surprisingly resilient. Still confident of their future prospects, homebuyers have increasingly turned to adjustable-rate mortgages to avoid some of the immediate costs of higher fixed mortgage rates.

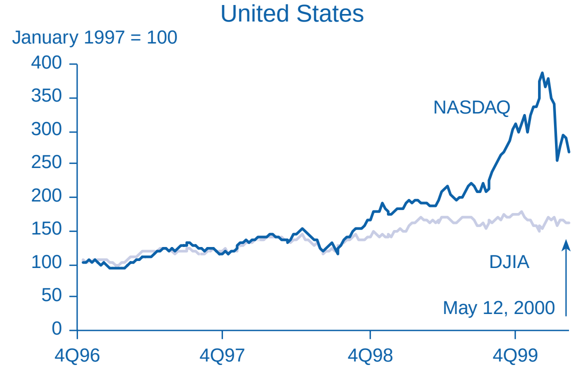
As for the business sector, higher costs for energy and debt service are most significantly affecting "Old Economy" firms that purchase commodity inputs and carry significant debt on their balance sheets. Airline companies in the S&P 500, for example, posted a year-over-year decline of 27 percent in net income from continuing operations during the first quarter of 2000.[21] Analysts have argued that New Economy firms, by contrast, are less vulnerable to recent economic shocks because they tend to carry little debt and consume relatively little energy.

Equity Market Volatility. The notion that New Economy firms are less vulnerable to the effects of higher energy costs and higher interest rates may be one of the reasons that equity shares of firms in the technology sector began to dramatically outperform the broader market, beginning around the middle of 1999. Chart 8 shows that the technology-heavy NASDAQ index performed more or less in tandem with the Dow Jones Industrial Average between the end of 1996 and the middle of 1999, but thereafter the NASDAQ soared far ahead of the Dow. Between October 1, 1999, and February 29, 2000, the NASDAQ rose by 72 percent while the Dow declined by 4 percent. Moreover, this striking divergence between the equity returns of Old and New Economy companies was not limited to the U.S. markets. Parallel trends were observed in Europe, Japan, Korea, and Hong Kong. The similarity in performance of the high-tech sectors across three continents suggests a worldwide flow of liquidity from investors to the shares of technology firms.

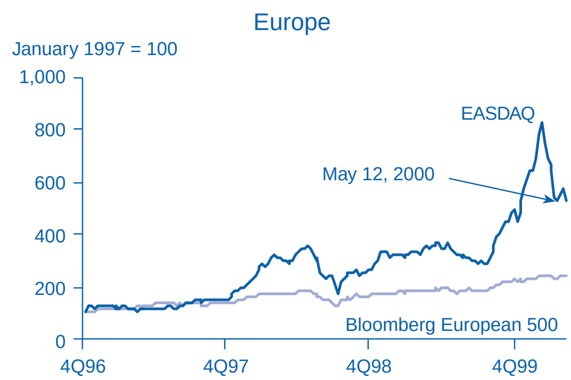
However, emerging concerns about the technology sector contributed to significant volatility in technology

CHART 8

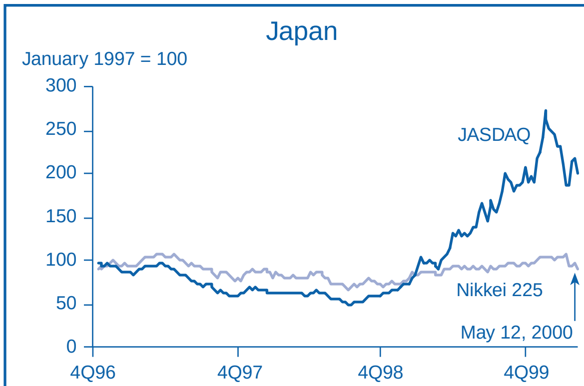
Tech Stocks Have, Until Recently, Far Outperformed "Old Economy" Stocks Worldwide



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

[21] Bloomberg. The S&P 500 airline industry is composed of AMR Corp., Delta Air Lines, Southwest Airlines, and U.S. Airways Group.

shares during March and April 2000. The NASDAQ index lost 30 percent of its value between March 10 and May 12, 2000. Analysts cited the Justice Department finding against Microsoft and doubts about the ultimate profitability of business-to-consumer Internet firms as two factors in the sell-off.

Equity market volatility also poses a threat to the economic outlook. One concern is the so-called "wealth effect" that a declining stock market may have on consumer spending. Since 1995, rising stock prices have helped raise the market value of equities held by U.S. households, plus their holdings of mutual funds, by some $5.7 trillion. This windfall is an important reason that households have continued to reduce annual personal savings (to just 2.4 percent of disposable income in 1999) and increase spending on homes, autos, and other consumer goods. Although it is uncertain what effect a prolonged stock market correction might have on consumer spending, the potential wealth effect has surely grown as more households hold a higher percentage of wealth in corporate equities and mutual fund shares. (See the inset box at right for a discussion of how financial market volatility could affect banks.)

The Economic Outlook

Despite the effects of rising energy costs, increasing interest rates, and equity market volatility, the U.S. economy continues to grow at a robust pace. The consensus forecast of 50 corporate economists surveyed by the May 1999 ***Blue Chip Economic Indicators*** suggests that the economy will grow by 4.7 percent in 2000, while consumer prices are projected to rise by 3.0 percent from 1999 levels. Short-term interest rates are projected to rise only slightly by year-end from early May levels. In short, the consensus forecast indicates that the New Economy formula of rapid economic growth combined with low inflation will continue for the foreseeable future. If actual events conform to this forecast, the result will likely be another year of generally low loan losses and solid earnings for much of the banking industry. (See the inset box on the following page for a discussion of other risks to watch in banking.)

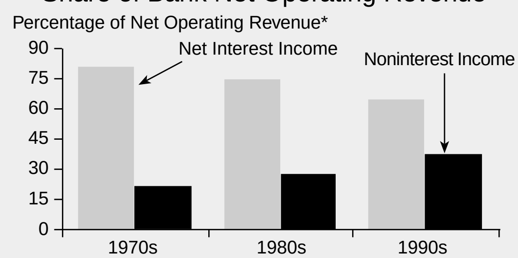
Clearly, risks are associated with the economic outlook. Recently, higher oil prices and higher interest rates have been the most visible signs of trouble for the economy. New Economy companies may be less vulnerable to these effects, but even these firms have experienced a sharp decrease in equity valuations as investors reeval-

Financial Market Volatility Could Pare Earnings for Banks Most Reliant on Market Sources of Revenue

FDIC-insured banks are deriving an increasing proportion of earnings from noninterest sources (see Chart 9), particularly market-sensitive sources of revenue. This is especially true for larger institutions. According to ***Deutsche Banc Alex. Brown,*** the 18 most active generators of market-sensitive sources of revenue earned over 25 percent of net operating revenue from these potentially volatile business lines.[22] While market-sensitive sources help to diversify revenue streams, they can also introduce increased income volatility in the event of financial market turbulence. Deutsche Banc Alex. Brown also reports that for those 18 banks that generated the largest amounts of market-sensitive revenues during the third quarter of 1998, the share of total revenue derived from market-sensitive sources declined from 23 percent to 13 percent. Thus, a more sustained downward trend in the financial markets could particularly affect the earnings of large banking companies that rely heavily on income from sources such as venture capital, asset management and brokerage services, and investment banking.

Chart 9

Noninterest Revenues Account for a Growing Share of Bank Net Operating Revenue



* Net operating revenue is the sum of net interest income and noninterest income.
Sources: FDIC Historical Statistics on Banking; FDIC Quarterly Banking Profile

[22] Net operating revenue is the sum of interest income and noninterest income less interest expense. According to Deutsche Banc Alex. Brown, these companies are Bank of America Corporation; Bank of New York Company, Inc.; Bank One Corporation; Bank Boston; BB&T Corporation; Chase Manhattan Corporation; Citigroup, Inc.; First Union Corporation; FleetBoston Financial; JP Morgan; KeyCorp; Mellon Financial Corporation; National City Corporation; PNC Bank Corp.; SunTrust Banks, Inc.; US Bancorp; Wachovia Corporation; and Wells Fargo & Company.

Other Risks to Watch in Banking

Subprime Lending

- ***Subprime consumer loan portfolios contributed to the large losses associated with recent high-cost bank failures.*** During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. The loss was primarily the result of an uptick in unanticipated and high-cost bank failures. FDIC-insured institutions with at least 20 percent of Tier 1 capital in subprime loans accounted for 6 of the 13 bank failures that occurred between January 1998 and March 2000. Fraud and inappropriate accounting for residuals also played a role in some of these failures.[23]

- ***Subprime lending remains an area of concern.*** Insured depository institutions that engage in subprime lending represent a disproportionate share of problem institutions. Of the 79 banks and thrifts on the problem bank list as of year-end 1999, 21 percent were institutions with at least 20 percent of their Tier 1 capital in subprime loans.[24]

Agricultural Lending

- ***While a majority of agricultural institutions remain relatively strong, external conditions have put pressure on some agricultural producers***. Many agricultural areas are experiencing low commodity prices as well as weather- and disease-related problems. Strong global competition and high worldwide production over the past several years have resulted in increasing inventories of many crops and poor prospects for a price turnaround in the near term. Moreover, in spite of record government farm payments in 1999, the U.S. Department of Agriculture projects that in the year 2000 one in four farms will not cover cash expenses, up to 20 percent of farmers will experience repayment problems, and 5 percent of farmers will be "vulnerable."[25]

[23] See Puwalski, Allen. FDIC Division of Insurance. Second quarter 1998. Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings. *Regional Outlook.* http://fdic01/division/doi/outlook/2q1998/atlanta/infocus1.html.

[24] The problem bank list includes all insured depository institutions rated a composite "4" or "5."

[25] "Vulnerable," as defined by the U.S. Department of Agriculture Economic Research Service, applies to institutions that have debt/asset ratios above 0.40 and negative income such that they cannot meet current expenses or reduce existing indebtedness.

- ***Some signs point to growing stress for agricultural institutions.*** Forty-two percent of FDIC-supervised banks active in agricultural lending showed a moderate or sharp increase in the level of carryover debt during third quarter 1999, compared with just 26 percent during third quarter 1998.[26] In addition, net loan loss rates for agricultural production loans increased in 1999 to the highest level since 1991. However, at 0.32 percent, the 1999 net loss rate is just one-tenth the rate experienced during the height of the agricultural crisis of the mid-1980s.[27]

Operational Risk

- ***Operational risks are becoming more prominent in the banking industry.*** Driven by consolidation and expansion into new product lines and markets, financial institutions are seeing an increase in operational complexity. Operational risk encompasses a host of factors not related to credit or market activities, including risks associated with processing transactions, legal liability, fraud, strategic missteps, and internal control weaknesses. Operational risks tend to be more pronounced when institutions engage in rapid growth, far-flung operations, and complex business processes.

- ***Greater attention is being paid to operational risks in the financial industry***. Recently, analysts have noted that the pressure to meet ambitious postmerger earnings predictions can result in cost-cutting measures that jeopardize the comprehensiveness and integrity of risk-management systems. In addition, the role that fraud has played in recent bank problems and failures reinforces the importance of adequate internal controls and audit procedures. The significance of operational risks to financial institutions has been noted in industry surveys and information-sharing efforts among financial firms.[28] NetRisk Inc., a Greenwich, Connecticut, consulting firm, recently estimated that operational losses among financial institutions have exceeded $40 billion over the past five years.

[26] September 1999. *FDIC Report on Underwriting Practices*.

[27] See Anderlik, John M., and Jeffrey W. Walser. FDIC Division of Insurance. Third quarter 1999. Agricultural Sector Under Stress: The 1980s and Today. *Regional Outlook.* http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/agricult.html.

[28] For additional detail, see March 2000. Operational Risk: The Next Frontier. *RMA/PricewaterhouseCoopers Survey.* April 6, 2000. Tech Bytes: Banks Join Forces Against Operational Risk. *American Banker.*

uate the long-term prospects. Equity market volatility threatens to dampen consumer confidence and the ability of businesses to continue to merge, restructure, and invest.

The economy has become particularly dependent on financing delivered through the capital markets. In this more permissive financial environment, rising debt levels and greater dependence on foreign capital have emerged as financial imbalances that may contribute to future problems for the economy. Businesses and households with high levels of debt are more vulnerable to problems if interest rates continue to rise or income growth falters. Rapid credit creation by the domestic financial sector suggests the possibility of lax credit underwriting standards. Reliance on foreign capital raises concerns about what would happen to the value of the dollar and to domestic inflation if foreign investors decide to invest elsewhere.

Some analysts suggest that the New Economy, driven by increased productivity, heightened competition, and robust investment, may be characterized by longer expansions. Financial market imbalances may, however, contribute to deeper recessions and more sluggish recoveries compared with earlier business cycles.

For the banking industry, it is clear that a recession would mean slower loan growth, deteriorating credit quality, and impaired profitability. But the biggest threat to the banking industry is a recession that is tied to disruptions in the financial markets. The ready availability of financing to start new businesses and restructure old businesses has been key to the New Economy. The process by which businesses have invested and restructured in response to competition has been orderly from the perspective of bank creditors. If this process should be disrupted, we could see a much more disorderly process, with more bankruptcies and higher losses to lenders.

This article was prepared and coordinated by the management and staff of the Analysis Branch of the Division of Insurance. Contributions and feedback from analysts across the Division were essential to its completion.

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